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Developing Governance and Regulation for Emerging Capital and Securities Markets

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ABSTRACT

This paper discusses various legal and regulatory issues for developing strong capital and securities markets in the transition economies. Toward this end, the paper analyses the available literature, and emphasizes that: (i) the development of corporate governance should be gradual and must take into consideration the customary laws that impact on the ownership structures and related preferences for doing business in the emerging markets; and (ii) the foreign investment policies should be consistent with the development of corporate governance and vice versa.

INTRODUCTION

Many scholars have proposed reform agendas for developing securities markets in the economies in transition. The most debated approach is to introduce U.S. laws to such economies to develop a U.S.-style securities market, and doing so would be essential to trigger economic growth.[1] While some scholars strongly suggest convergence of the corporate governance regimes to the U.S. model is a good way forward, others argue against this notion, highlighting the peculiar institutional make-up of the U.S. securities market that cannot be exported merely by changing the laws on the books.[2] The scholars arguing against convergence also highlight significant and distinct socio-economic and political features of each society that may not only resist the reforms by way of

The author is grateful to Professor Troy Paredes for providing specific guidance on the issues discussed in this paper. The author also takes this opportunity to thank Professor John Coffee, Professor John Haley, Professor Stanley Paulson and Professor John Drobak for providing guidance in respect of issues related to the discussion herein. The present work would not have been possible without the profound guidance of the noted scholars. Of course, the omissions remain my own.

[1] Troy A. Paredes, *A Systems Approach to Corporate Governance Reform: Why Importing U.S. Corporate Law Isn't the Answer*, 45 WM. & MARY L. REV. 1055 (2004). (Quoting the works of Rafael La Porta et al.)
[2] To quote a few, s*ee generally* Katharina Pistor et al., *Law and Finance in Transition Economies*, 8 Econ. of Transition 325 (2000); Bernard S. Black et al., Final Report and Legal Reform Recommendations to the Ministry of Justice of the Republic of Korea, 26 J. CORP. L. 546 (2001); Bernard S. Black, The Legal and Institutional Preconditions for Strong Securities Markets, 48 UCLA L. REV. 781 (2001); Cally Jordan, The Conundrum of Corporate Governance, 30 BROOK. J. INT'L L. 983 (2005); Troy A. Paredes, A Systems Approach to Corporate Governance Reform: Why Importing U.S. Corporate Law Isn't the Answer, 45 WM. & MARY L. REV. 1055 (2004); William W. Bratton & Joseph A. McCahery, *Comparative Corporate Governance and the Theory of the Firm: the Case Against Global Cross Reference*, 38 COLUM. J. TRANSNAT'L L. 213 (1999).

transplant, but may also persist. A renowned scholar has noted an intermediate position.[3] This position "has predicted that formal institutional variations in corporate law and practice will remain, but will be overshadowed by an increasing degree of functional convergence."[4]

Among the scholars that argue for the significance of culture, some have further suggested that recognizing the national cultures is important before embarking reforming corporate governance.[5] To explain the above with regard to the transition economies, a tussle between the modern reforms and the local culture may generally exist at the level of ownership structure and corporate transactions. Such ownership structures and transactions emanate from the cultural practices; or more precisely the customary law. For instance, customary practices discourage separation of ownership and control and are commonly in practice in emerging economies such as Bangladesh, India and Pakistan. As for the culturally consistent corporate transactions, a large number of the population in various transition economies including Indonesia, Malaysia, India, Bangladesh, Pakistan and the Middle-Eastern economies demands conducting corporate transactions and businesses in accordance with the principles of Islamic finance. Accordingly, cultural factors including customary law are relevant for developing capital markets in the emerging economies due to their significant impact on ownership structure of the firms and the people's preference for doing business. However, a distinction between culture and customary law is not available in the comparative corporate governance literature, although such distinction exists in jurisprudence.[6]

As a note of clarification, culturally-neutral modern regulatory reforms that seek to upgrade the capital and securities markets and do not clash with the local cultures and customary law are not the focus of discussion herein. Although such reform will have a

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[3] Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 329 (2001).

[4] John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641 (1999) (discussing formal and functional convergence in foot note 27).

[5] Amir N. Licht, *The Mother of All Path Dependencies Toward a Cross-Cultural Theory of Corporate Governance Systems*, 26 DEL. J. CORP. L. 147, 203 (2001).

[6] *See generally* THE PRINCIPLES OF SOCIAL ORDER (Kenneth I. Winston ed., 2001).

better success rate in the emerging markets, the developing countries should be careful in learning from the experiences of more advanced countries and importing regulatory structures because of the variation in the underlying differences of such structures.[7]

With the exception of some countries, the securities markets in most of the transition economies do not significantly contribute to the economic growth at the macro-level, despite various reform initiatives, including those sponsored by international development organizations. Despite this, in an effort to connect the economic reforms with economic growth, the transition economies are constantly working to modernize the legal structure to increase efficiency of the capital markets and facilitate foreign investment. The emerging economies are also implementing various strategies to attract foreign investment in their securities markets, and often start with adopting the codes of corporate governance from the developed markets. However, the success of such reforms is likely to be hindered by ignoring indigenous legal frameworks including the customary law. Taking such indigenous sources of law into consideration could help create strong and deep securities markets in transition economies, and thus contribute to economic growth. Furthermore, robust investment policies have not been able to turn the emerging securities markets to a success. This paper will highlight some of the possible causes that could explain lack of foreign investment in the emerging securities markets.

As noted, the "reforms may be more difficult, as their success would depend on the more general structure and efficiency of legal systems in different countries."[8] The success of such reforms for developing countries depends on specific analysis of customary laws and examination of foreign investment policies of such economies, before reforming and implementing a new corporate governance regime that is intended to boost economic growth. The institutional make-up of the transition economies, specifically the customary law, provides better insight to the existing corporate governance regime. Overlooking such institutions in the reforms process will cast serious doubt on the

[7] Howell E. Jackson, *Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications* 12-14 (Har. Law Sch. Program on Corp. Governance, Discussion Paper No. 521of 2005), *available at* http://www.law.harvard.edu/programs/olin_center/papers/pdf/Jackson_521.pdf.
[8] Simeon Djankov et al., *The Law and Economics of Self-Dealing* (Nat'l Bureau of Econ. Research, Working Paper No. 11883), *available at* http://papers.nber.org/papers/w11883.

efficacy of the corporate governance reforms in the emerging markets. This paper argues against replacing customary practices with the modern unfamiliar reforms. In the event that any customary practice results in market abuse or otherwise hinders market growth, as discussed below, such practices should be gradually replaced with equally efficacious alternates.

While indicating various policies and initiatives of the emerging markets, this paper will refer to Pakistan[9] for explaining the jurisdiction-specific instances that Pakistan has in common with other emerging markets.

The discussion in this paper is organized to present issues in relation to development of the capital markets, convergence of corporate governance and perspectives from the international securities markets. Accordingly, Part I outlines features of strong capital markets, focusing primarily on the equity markets. Part II analyzes issues in respect of convergence of corporate governance. Part III leads the discussion to the developing securities markets in the transition economies and analyzes their possible international competitiveness. This part also discusses issues such as regulatory convergence and foreign investment policies. The paper concludes with observations highlighting prospects of future reforms and the distinct jurisdictional character of the emerging markets that is essential to understand before embarking upon reform initiatives for the capital and securities markets in such economies.

[9] Among others, Pakistan is also classified as an emerging market, in terms of the criteria of per capita income and governmental restrictions and involvements with listed companies and foreign investors. *See* Standard and Poor's & International Finance Corporation, Emerging Stock Markets Fact Factbook 2000, 2 (2000).

I. DEVELOPING CAPITAL MARKETS IN TRANSITION ECONOMIES

A. Fostering Capital Markets

Capital markets facilitate securities' transactions in debt and equity and thereby supply financial resources in the financial markets. With increased activity of transactions, access to cash becomes easier and the capital markets become efficient, creating enough liquidity in the market that spreads the economic and financial benefits to the market participants. More the number of the participants deeper get the capital markets, and, therefore, deeper markets generate a larger financial activity. Deep capital markets improve economic growth at micro and macro level.[10] Or, put differently, there is simply a larger pool of available capital that enterprises can tap into to finance their activities.

Owing to divergence of issues in the debt and equity markets, the discussion below refers only to the equity markets.

Law Matters

Recent empirical studies have shown that developing capital markets is a result of appropriate legal framework, or that "law matters." The "law matters thesis,"[11] mainly emphasizes strong protections for the minority shareholders. Recent reiteration[12] of the law matters thesis, with "new emphasis on self-dealing,"[13] recommends that effective regulation of "large self-dealing transactions,"[14] their "full disclosure"[15] and "giving

[10] *See generally* Rafael La Porta et al., *Law and Finance*, J. POL. ECO. 1113, 1152 (1998).
[11] This expression was employed to describe the earlier works in the series of works by Simeon Djankov et al. and Rafael La Porta et al. *See generally* Paredes, *supra* note 1 (discussing "law matters thesis"); John C. Coffee, Jr., *Racing Towards the Top?: The Impact of Cross-Listing and Stock Market Competition on International Corporate Governance*, 102 COLUM. L. REV. 1757 (discussing "law matters").
[12] Djankov et al., *supra* note 8.
[13] *Id.* at 1.
[14] *Id*. at 37.
[15] *Id*.

aggrieved shareholders standing to sue, access to information…and a low burden of proof"[16] is required for the development of securities markets. Likewise, another study concluded that "securities laws matter"[17] for prosperity of the financial markets.[18]

Since the capital markets contribute to the economic growth and development, poor investor protection results in smaller capital markets. Accordingly, good legal protections for investors and economic development are interlinked.[19]

Although development can be accomplished via government ownership of banks, such governmental control does not result in rapid economic growth.[20] Government ownership of Banks is associated with slower financial and economic development.[21] Poorly protected property rights and underdeveloped financial system give rise to government ownership of banks.[22] In sum, government ownership of banks does not create an efficient financial development.[23] However, the role of banks, in general, and the role of nationalized bank in the transition economies appears relevant to various initiatives that may not otherwise have been taken to accelerate economic growth. To quote an instance, in Pakistan, the provision of agricultural loans and write-off policy in case of crop failure continue to benefit small farming industry.

Recent studies bring evidence in an effort to answer why the United States and the United Kingdom have larger equity markets then Germany in France, and found that protections by way of legal rules and their enforcement have strong effects on the size and breadth of

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[16] *Id*. (The earlier studies of in the series of The Law and Economics of Self-Dealing were criticized for ignoring "private action."). *See generally* John C. Coffee, *supra* note 4, at 1829.
[17] Rafael La Porta, et al., *What Works in Securities Laws?*, 61 J. FIN 1 (2006).
[18] *Id*.
[19] Rafael La Porta et al., *Law and Finance*, J. POL. ECO. 1113, 1152 (1998). (Although there were inconsistencies found in data gathering and coding techniques, the study remains a pioneering work. *See generally* Holger Spamann, *On the Insignificance and/or Endogeneity of La Porta et al.'s 'Anti-Director Rights Index' under Consistent Coding*, (Har. Law Sch. Program on Corp. Governance, Discussion Paper No. 7 of 2006), *available at* http://www.law.harvard.edu/programs/olin_center/fellows_papers/pdf/Spamann_7.pdf).
[20] Rafael La Porta et al., *Government Ownership of Banks*, 57 J. FIN 265, 284 (2002).
[21] *Id.* at 290.
[22] *Id.* at 266. (Also arguing that the governments, through banks, provide subsidies and employments but also use the banks to reciprocate the political favors).
[23] *Id.* at 284.

capital markets.[24] Good legal protection of potential financiers against possible expropriation by entrepreneurs ensures more funds, and hence expands the size of capital markets.[25]

Today, financial globalization enables international investors to share the risk better and allows the capital to flow toward the most productive markets, and provides respective countries to reap the benefits of their comparative advantages.[26] This, however, requires a structure of corporate governance that not only recognizes property rights but also provides effective enforcement to safeguard them. As discussed below, such safeguards emanate primarily from the laws, enforcement mechanisms, and non-legal measures "such as market pressures, contracts, and norms of good practice that directors and officers follow."[27] Among such rights are improved legal protections for shareholders. However, presence of such protections is not the only solution for developing external finance in transition economies.[28] A scholar has argued against the findings in an earlier study[29] to note that "effective law enforcement is not a substitute for poor laws on the books" and concluded that "good laws cannot substitute for weak [legal] institutions" in the transition economies.[30] In this context, it is pertinent to note that effective enforcement is always crucial with or without good laws on the books, with the difference that good laws with effective enforcement will achieve far greater results in developing capital markets.

The variables that are relevant to explain U.S. and European capital structures have been found relevant in the similar analysis for the developing countries.[31] However, development of financial and securities markets in the transition economies requires more specific studies that could, *inter alia*, examine the cultural practices and social norms to

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24 Rafael La Porta et al., *Legal Determinants pf External Finance*, 52 J. FIN. 1131, 1132 and 1149 (1997).
25 *Id.* at 1149.
26 Rene M. Stulz, *The Limits of Financial Globalization*, 60 J. FIN. 1595, 1595 (2005).
27 Paredes, *supra* note 1, at 1074.
28 Katharina Pistor et al., *Law and Finance in Transition Economies*, 8 ECON. OF TRANSITION 325, 356 (2000).
29 La Porta et al., *supra* note 19, at 1152.
30 Pistor et al., *supra* note 28, at 356.
31 Laurence Booth et al., *Capital Structures in Developing Countries*, 56 J. FIN. 87 (2001).

identify the "general structure and efficiency of legal systems" in such economies, and thereby inform the reform process for appropriate corporate law and governance. While categorizing corporate governance initiatives to economic and legal institutions, an argument suggests that a political process may change such institutions for the better.[32]

In sum, capital markets, including those in the emerging economies, cannot flourish without an appropriate legal framework that reduces subjective decision making and encourages transparent and objective enforcement of laws and the related regulatory framework. Certainty as to the working and fairness of the systems will attract more participation in financial market, and will curb interest groups that benefit from its weakness. Law should also build upon the social and cultural factors that enjoy similar force or obedience, such as customary laws.

Agency Problems: Self-Dealing and Investor Protection

In general, the foundations of the market systems include compelling transparency, prohibiting insider-dealing and policing self-dealing.[33] "Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment"[34] and it also "deals with the agency problem: separation of management and finance."[35] Investor protections and market development go hand in hand in the real world, and if "protections are absent, one-sided deals flourish and outside equity capital either becomes more expensive or dries up altogether."[36]

[32] Adnrei Shleifer et al., *A Survey of Corporate Governance*, J. FIN. 737, 738 (1997). For further treatment of the argument *see also* Rene M. Stulz & Rohan Williamson, *Culture, Openness and Finance*, 70 J. FIN. ECON. 313, 346 (2003); Mark J. Roe, *Can Culture Constrain the Economic Model of Corporate Law?*, 69 U. CHI. L. REV. 1251, at 1253, 1265, 1268; Amir N. Licht, et al., *Culture, Law and Corporate Governance*, 25 Int'l Rev. L. & Econ. 229; and Ok-Rial Song, *The Legacy of Controlling Minority Structure: A Kaleidoscope of Corporate Governance Reforms in Korean Chaebol*, 34 LAW & POLICY INT'L BUS. 183, 187.
[33] William W. Bratton & Joseph A. McCahery, *Comparative Corporate Governance and the Theory of the Firm: the Case Against Global Cross Reference*, 38 COLUM. J. TRANSNAT'L L. 213, 296-97 (1999).
[34] Shleifer et al., *supra* note 32, at 737.
[35] *Id.* at 773.
[36] Bratton & McCahery, *supra* note 33, at 297.

To counter the agency problem, one of the arguments is that small investors cannot be attracted to the business of financing companies without legal protections against expropriation by managers and large investors.[37] Greater protections for shareholders strongly predict the stock market development.[38] Effective regulation of self-dealing is the fundamental element of shareholder protection[39] that also results in dispersion of ownership.[40]

The corporate model of "separation of ownership and control"[41] is popular in the richest common law countries. Outside the United States, especially in countries with poor investor protection, the largest firms tend to have controlling shareholders.[42] There may be greater reliance on debt financing rather than equity financing in such countries.[43] Ownership concentration is a consequence of poor legal protection of minority shareholders.[44] However, in concentration of ownership, the protections for investors may be complementary to corporate governance.[45] On a related issue of redistribution of wealth in the economy, the large investors could be ineffective, even though they may effectively control the agency problem.[46]

Qualitative minority protection is equally significant for successful dividend policies. Shareholders, in countries with better protections, are willing to wait for the dividends for better investment opportunities in future and receive higher dividends. Shareholders with poor protections apparently take whatever they can get and do not wait, fearing expropriation.[47] More protections limit expropriation and result in higher dividends.[48]

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[37] Shleifer et al., *supra* note 32, at 769.
[38] Djankov et al., *supra* note 8, at 34.
[39] *Id.* at 35.
[40] Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471, 496 (1999).
[41] *See* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).
[42] La Porta et al., *supra* note 40, at 511.
[43] *Id.* at 508.
[44] *Id.* at 511.
[45] Shleifer et al., *supra* note 32, at 773.
[46] *Id.* at 774.
[47] Rafael La Porta et al., *Agency Problems and Dividend Policies Around the World*, 55 J. FIN. 1, 27 (2000).
[48] *Id.*

In countries with poor protections, the larger firms have ultimate owners, such as family, State or financial institutions.[49] Globally, forty-five percent of the medium-sized firms are family-owned. Bank-based ownership structure, like in Germany, is not the most common one; it is the family ownership.[50] But, in countries with poor investor protection, widely held firms are otherwise exceptions.[51] However, the family control is likely to facilitate corruption, and is more important in the most corrupt countries.[52]

By limiting expropriation, the law raises the securities' price in the market, and thus encourages more entrepreneurs to seek external finance. This expands the financial markets.[53] In countries of poor investor protections, poor shareholder protections result in lower valuations, but the higher cash-flow ownership by the controlling shareholders improves valuation.[54]

On-going disclosure of self-dealing transactions benefits the stock market development.[55] Aggrieved shareholders having standing to sue, access to information regarding self-dealing and a low burden of proof is likely to deter the self-dealing, and would promote stock market development.[56] The best strategy for avoiding self-dealing appears to be the reliance on "extensive disclosure, approval by disinterested shareholders and private enforcement."[57]

Quality of information regarding the value of company's business and confidence against self-dealing are the preconditions for strong public securities markets.[58] Honest courts and government, regulators and prosecutors are important, and should be homegrown

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[49] Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471, 497 (1999).
[50] *Id.* at 496.
[51] *Id.* at 498.
[52] *Id.* at 510.
[53] Rafael La Porta et al., *Investor Protection and Corporate Valuation*, 57 J. FIN. 1147, 1147 (2002).
[54] *Id.* at 1168.
[55] Djankov et al., *supra* note 8, at 37.
[56] *Id.*
[57] *Id.* at 38.
[58] Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 783 (2001).

before the market development.[59] Suggestions for long-term steps include strengthening business and law schools, training young people and developing reputation intermediaries.[60] The reputation intermediaries, however, are not likely to grow in anticipation of market growth; but their increasing demand will facilitate their growth in the emerging markets.

The studies have examined anti-self-dealing measure for their relationship to financial markets development[61] and found that a high anti-self-dealing index was associated with valuable stock markets.[62]

While laws against self-dealing—and their effective enforcement—are crucial for the emerging markets, the economies in transition face the additional challenge of "twin agency problems" in international investments and financial globalizations. That is to say, one of the corporate insider's discretion and, the second, of the political or state-ruler's discretion. The central role of the twin agency problem appears to remain unaffected for fostering ownership concentration.[63] "[I]nvestment in corporate governance is less profitable in countries in which the agency problem of state ruler discretion is significant because many activities that entrench corporate insiders help reduce the risk of expropriation by the state." [64]

Fighting agency problem is equally crucial for the emerging markets. Effective transparency and accountability will ensure flow of the corporate profits to the investors. Expectancy of profit and security of investment will encourage a larger number of investors to move their bank deposits to the capital markets, a trend that is direly needed in the transition economies.

[59] *Id.* at 848.
[60] *Id.*
[61] Djankov et al., *supra* note 8, at 2.
[62] *Id.* at 27.
[63] Stulz, *supra* note 26, at 1633.
[64] *Id.* at 1634.

Effective Enforcement

It has been argued that effective law enforcement by the legal institutions is more important for enterprise finance in the transition economies than the laws on the books.[65] This argument will be accurate upon assumption that there is no room or possibility for improving the laws on the books, and effective enforcement is the only option for ensuring best results in the given scenario. However, this assumption simply does not exist in the transition economies. Almost competing with each other, the emerging markets are taking serious measures to improve the legal framework mainly for attracting foreign investment. In these circumstances, the economies of transition must be reminded that effective enforcement will always be equally important. Put differently, modern legal reforms should go hand in hand with the improvements in the enforcement mechanisms.

Scholars have considered public involvement to be crucial for the development of financial markets and, therefore, the public sector has a key role to play: designing the rules that may be enforced.[66] Arguing further, it was noted that securities law matter, as it facilitate private contracting[67] and that financial markets may not prosper if left to market forces alone.[68] Without taking the above arguments in the proposed generality, the above arguments appear more relevant for the economies in transition that are yet to ensure either basic legal protections or, if such protections exist, their effective enforcement. In the absence of substantive rights and their effective enforcement, the emerging capital markets are not likely to mark their success. Features like market discipline, private litigation, private contracting, standardized disclosure and private dispute resolution within market-friendly standards of liability have been considered relevant for stock market development.[69] In the emerging markets, the above features would be relevant if introduced gradually and in a culturally neutral manner.

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[65] Pistor et al., *supra* note 28, at 328.
[66] Djankov et al., *supra* note 8, at 37.
[67] La Porta, et al., *supra* note 17, at 28.
[68] *Id.* at 27.
[69] *Id.* at 28.

In general, public enforcement does not predict more developed stock markets.[70] It also does not predict development of securities markets in transition economies[71] and cannot provide an economic jump start to securities markets in poor countries.[72] In successful stock markets, the shareholders receive the pertinent information that they may use for voting or for private action.[73]

In contrast to having an elaborate legal system outlining the governance mechanism, administrative governance, by way of a quota-based administrative selection of firms from the administrative geographical regions to be eligible to go public, has provided a jump-start to China's stock market. However, administrative governance has its limitation, and has not been considered a replacement for a standard legal regime.[74] Accordingly, such a mechanism will not be workable for the transition economies because this will reduce the focus of developing legal institutions in such economies. The involvement of administrative discretion is most likely to further destabilize the developing legal structure.

As recently confirmed, expensive implementation through a focused regulator,[75] democratic and political rights,[76] criminal sanctions,[77] and fines[78] do not matter for developing stock markets. However, the above would matter for the developing countries, although the studies do not specifically address the issues of emerging markets in this respect. Developing capital markets are usually dominated by interest groups that stall the reforms that seek to circumvent their vested interests. Such groups promote insider dealings and related market abuses to the detriment of the other market participants. Proper enforcement, through legal institutions and effective regulator,

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[70] Djankov et al., *supra* note 8, at 27. (Arguing also, regarding the enforcement of laws, that the richer countries have better results *see generally* La Porta et al., *supra* note 24 at 1132.
[71] La Porta, et al., *supra* note 17, at 25.
[72] *Id.* at 25.
[73] Djankov et al., *supra* note 8, at 37.
[74] Katharina Pistor & Chenggang Xu, *Governing Stock Markets in Transition Economies: Lessons from China*, 7 AM. L. & ECON. REV. 184, 207 (2005).
[75] La Porta, et al., *supra* note 17, at 27.
[76] *Id.* at 25.
[77] *Id.* at 28.
[78] Djankov et al., *supra* note 8, at 37-38.

criminal sanctions and fines, will safeguard against expropriation, and will help prevent destabilization caused by the market abuses. As for relevance of democratic and political rights, they will allow common understanding of corporate democracy and empower minority shareholders to assert their rights. As such, in the absence of the developed market legal and non-legal institutions, the role of the regulator, criminal sanctions and fines become more significant to help avoid market malpractices, and across the board enforcement is likely to encourage the market growth.

Effective and transparent accountability at the macro-level strengthens people's confidence on their rights, and discourages those who would benefit from the weaknesses of the system. Developing capital markets cannot grow if norms like the rule of law are missing in society. A general tendency to disregard the rule of law, which, unfortunately, is widespread in most of the transition economies, shapes a culture of lawlessness that not only adversely impacts the growth of the capital markets but also the overall economic growth. The culture of lawlessness breeds expropriation in the developing capital markets. Therefore, for the transition economies, the legal culture of effective implementation and enforcement should receive greater attention, because no legal or regulatory measures would be fruitful in its absence.[79]

B. Formation of Trust

Illiteracy is rampant in most of the transition economies, and the appreciation for the human interaction and collective engagement in civic activities is accordingly lacking. Indeed, most of such population cannot read and write, and live in a dreadful poverty. Mobilizing them toward positive civic and infrastructural engagement would entail allocation of substantial financial resources that first of all help them meet their needs. Painfully, most of the transition economies lack such financial resources. Therefore, society's ability to foster social capital remains seriously impaired. For the same reasons, impairment is far greater for expanding network of social capital to foreigners.

[79] Benny S. Tabalujan, *Why Indonesian Corporate Governance Failed - Conjectures Concerning Legal Culture*, 15 COLUM. J. ASIAN L. 141, 169-171 (2002).

Social welfare initiatives by the affluent part of the society, for instance, in Pakistan has sought to bridge the absence of social capital. Similar international initiatives have generated goodwill for the foreigners. Increasing steps for better cultural representation and sponsoring public welfare projects by foreign firms and foreign governments are successfully nurturing the social capital. Continued similar initiatives will significantly reduce any unfriendliness or hostility in the transition economies.[80]

Lack of trust in a society may result in judicial system that cannot guarantee reliable enforcement.[81] As defined, "trust is a habit formed during a centuries-long history of horizontal networks of association between people, covering both commercial and civic activities."[82] Building upon an existing argument that "trust or social capital determines the performance of the society's institution,"[83] some scholars have explored "the forces that encourage the formation of trust" and endorsed the argument. The scholars noted that "trust should be more essential for ensuring cooperation between strangers…than for supporting cooperation among people who interact frequently."[84]

Regarding foreign investment in the transition economies, one of the main questions appears to be whether foreign investors would trust the local investors for participation in their ventures, and vice versa. Formation of trust, therefore, appears essential in the transition economies. However, it has been argued that securities laws may serve as proxy for trust.[85] But such laws can only serve the purpose if the capital markets are already popular and flourishing. In order to create such a level of growth, developing and strengthening trust within the society appears essential for the transition economies.

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[80] For instance, establishing missionary hospitals, schools and similar philanthropic initiatives helped the imperial governments in generating positive sentiments within the colonized India. Today, such initiatives from various developed countries continue to achieve such results in Pakistan. To provide a recent example, the Pakistan subsidiary of the British American Tobacco has launched eye hospitals and contribute to the cancer hospitals.
[81] Pistor et al., *supra* note 28 at 328.
[82] Rafael La Porta et al., *Trust in Large Organizations*, AMER. ECO. REV., 333, 336 (1997).
[83] *Id.* at 333.
[84] *Id.*
[85] La Porta, et al., *supra* note 17 at 25.

An analysis is important as to how a particular society regards people from different social origins. One social force that encourages—or discourages—social interaction stems from religion. Empirical confirmations are available that "hierarchical religion discourages horizontal ties between [the people] and hence the formation of trust."[86] The findings suggest that adherence to hierarchical religion, including Christianity, are likely to lack formation of trust within the society. However, other studies have found better enforcement and protection of creditors' right in Protestant countries. The reasons explained in this regard include that centralization arises out of people's dependence on a religious group for seeking knowledge, and hence does not encourage people to seek knowledge independently. Specific studies in regard to the transition economies analyzing effects of religion on the capital markets in such economies are not available. Future studies highlighting such issues will assist the emerging economies devising future strategies for the growth and development of the capital and securities markets.

Because a majority of the transition economies share a history of colonization, the transition economies may not be able to ensure formation of trust with the foreign investors because of the historical sentiments of dislike toward the foreigners, and such sentiments may still exist at the micro-level. The scholars, while discussing issues regarding formation of trust, have not discussed this possible aspect of inquiry. The scholars have also erred in their finding about the Muslim emerging markets.[87] Therefore, a comprehensive work examining the development of trust that is essential for the growth of capital markets is needed.

As for developing trust between the locals and foreign investors in the transition economies, such formation of trust is likely to occur more easily after the capital markets have started to be profitable to the locals. Profit motives will make it easier for the locals

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[86] La Porta et al., *supra* note 82, at 333. (Quotation marks omitted).
[87] La Porta et al., *supra* note 82, at 336. (The authors have noted that Muslim countries have "hierarchical religion." Islam does not encourage hierarchical division amongst the people rather it mandates horizontal proximity. The Muslim countries' inability to turn their social capital or trust into the industrial success does not appear to be on account of any (hierarchical or otherwise) religious adherence, but it may have other reasons, such as absence and non-development of corporate vehicle in the Islamic societies in the previous centuries. *See generally* Timur Kuran, *The Absence of the Corporation in Islamic Law: Origins and Persistence*, (Working Paper No. 585687), *available at* http://ssrn.com/abstract=585687).

to more openly welcome the foreign investors in the capital markets. Policies of attracting foreign investment in the transition economy lack understanding of this aspect and rely more on developing the market through the foreign investment. Such approach is less likely to work. The locals without having the opportunity to maximize their wealth in their own capital markets are likely to resent the foreign investors, and may classify them at par with the colonial looters. Such sentiments would work against the developing strong capital markets in the emerging economies.

C. Cultures and Customs[88]

While understanding corporate governance across countries, culture—including religion—must be kept in view. In other words, culture matters.[89] Some scholars have found correlation between culture and development of debt and banking markets.[90] Other scholars have highlighted its relevance for developing capital markets.[91]

Norm and Law

A notable scholar has suggested a significance and prevalence of norms in circumstances where the law remains weak or fails to provide reasonable protection. Noting a converse suggestion, it was added that the importance of norms is likely to fade away when law provides adequate remedial recourse.[92] However, it remains to be seen whether the established social norms in the developing economies are likely to persist; notwithstanding the introduction of new rules that remain unfamiliar, unless the new rules draw upon the existing norms.[93] Indigenous culture can reassert itself forcefully in

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[88] *See also infra* Part III below.
[89] Stulz & Williamson, *supra* note 32, at 346. (However, the authors have not treated Islamic law to be relevant legal system for investor protection even for the Muslim countries where Islamic law has been practiced for centuries.) *See also* Roe, *supra* note 32; Licht, et al., *supra* note 32; and Song, *supra* note 32.
[90] *See* Stulz & Williamson, at 316. (The study confirmed that legal origins matter for the development of the stock markets, in contrast to significance of culture for debt markets).
[91] *See generally* Roe, *supra* note 32; Licht, et al., *supra* note 32; and Song, *supra* note 32.
[92] John C. Coffee, Jr., *Do Norms Matter? A Cross-Country Evaluation*, 149 U. PA. L. REV. 2151, 2175-77.
[93] A possible argument could be based upon unfamiliarity of the modern reforms that are likely to attract resentment, particularly in countries with colonial legal history. For instance, if one argues against

transition economies.[94] The studies have discussed countries' adopting "their legal systems involuntarily (through conquest or colonization)"[95] but such studies did not examine the efficacy of such rules. These rules may well be on the books even enforced, yet it is debatable whether such rules enjoy popularity at the grass-roots level. The people in such societies may still look for a customary or religious source of law.

Evaluating drawbacks of the cultural norms, a relationship-based system of governance may be more practical for the transition economies, but it will inevitably result in the misallocation of capital that discourages the entrepreneurs.[96] As another drawback of a relationship-based system, it will exclude foreigners from the operating circle of the market.

A recent study has left many questions unanswered about the equity markets of the developing countries.[97] Adding to that list of questions, it remains to be examined whether there is a lack of compliance with the modern transplanted rule; and, instead of law, there is adherence to the customary business practices and norms.[98] Customary laws that often shape the corporate behavior and ownership structures appear more significant for the economies in transition.

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adherence to the rule of law in Pakistan, one reason for such social tendency could be explained that the law itself is being perceived as a colonial legacy, and hence, perceived to deserve lesser regard. The resentment toward a foreign set of rules breeds disregard or violation and, therefore, corruption may follows in most cases.

[94] Stulz & Williamson, *supra* note 32, at 346. (The authors specifically note this possibility for the countries with the history of being colonized).

[95] La Porta et al., *supra* note 19, at 1126.

[96] Coffee, *supra* note 4, at 706.

[97] Shleifer et al., *supra* note 32, at 774.

[98] *See* Jeffrey D. Sach & Ghiath Shabsigh, Economic Development and the Muslim World, *available at* http://ifptest.law.harvard.edu/ifphtml/pdfs/Seminar_FT.pdf. (Explaining reasons for unprecedented growth of Islamic banking, insurance, personal finance and *Shariah* debt instruments in the emerging Muslim markets). *See also infra* note 109 (for detailed measures taken by the Security and Exchange Commission of Pakistan. Further to the recent stock market crash in March 2005 (known as the March correction), the Securities and Exchange Commission of Pakistan concluded the customary carry-over transactions ("COT") were the root cause. The Commission declared the COT transactions as void with effect from December 31, 2005 and issued a continuous finance system as an interim measure. However, apparently due to the market pressure, the Chairman of the Commission was replaced in January 2006. This was a strong indication that customary practices are likely to persist. As suggested by Prof. John Coffee, this could be an evidence of the clash of power groups, *see* Coffee, *supra* note 11, at 830.)

Customary law

Informal constraints, social norms and formal laws could be categorized as "institutions" within the meaning ascribed thereto by the neo-institutional economics.[99] Customary law fits well in the category. Customary law may be understood as part of the conscience of a community[100] and exists even in the modern communities parallel to the statutory law.[101] More specifically, "custom become law when it is known to be law, is accepted as law and practiced as law."[102]

As for Pakistan, Bangladesh, India and the Muslim Middle-Eastern countries, Islamic and other local laws became the customary law once transplantation of the colonial legislation commenced; the local laws were enforced by the writ of state before colonization. For instance, the British revived Islamic and Hindu laws by legislation in the united India to the extent of partnership, family and inheritance issues, and termed them as "personal laws." However, the judges in Pakistan, Bangladesh, India, interchangeably use the expression "customary law" and "personal laws."

Forming customary laws for economic and business transactions, cultural practices and social norms play an influential role in Pakistan's economy and on Pakistan's doing-business scenario. The diversity arises out of two customary sources: the customary norms of doing business in the Indian sub-continent, and Islamic law. The major local firms are organized in the form of a family ownership resembling the "Hindu Joint Family System"[103] and, on the other hand, the Islamic principles of doing business require a peculiar form and substance of transactions.

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[99] Katharina Pistor, *Patterns of Legal Change: Shareholder and Creditor Rights In Transition Economies*, 1 EUR. BUS. ORG. L. REV. 59, 61 (2000).
[100] *See* HAROLD J. BERMAN, LAW AND REVOLUTION, 11 (1983).
[101] ALAN WATSON, THE EVOLUTION OF WESTERN PRIVATE LAW, 91 (2001).
[102] *Id.* at 93.
[103] This system exists particularly, in India, Bangladesh and Pakistan in the customary form of family ownership in which the head of the family is the head of the firm.

As for the Hindu Joint Family System, the owners prefer to manage the firm themselves and do not welcome non-family managers. Firms resembling such structure rarely disperse ownership, and while doing so prefer to retain as much percentage as is necessary to keep the minority shareholders out of the boardroom and below the statutory threshold for maintaining minority action. It appears that such firms go public only to get listing-related benefits, including ability to have better rating for issuing debt securities in the local and international market. The firms structured on this pattern do not separate ownership and control. In a Hindu Joint Family System, the elder of the household is the *karta*[104] of the family business. It may be pertinent to mention that in all the colonial legislation in the united India, the British expressly kept distinguishing the Hindu Joint Family System with the partnership and corporation so that such laws do not regulate it. In the Hindu Joint Family System, after the father (who is ex officio *karta*) the title devolves to the eldest of the male offspring, and so on. Although the businesses are now incorporated, but most of the leading firms in Pakistan and India internally represent Hindu Joint Family System.

As for adherence to the principles of Islamic finance, the market for the products based on Islamic finance is exceeding US$ 400 billion. Ten years ago the numbers were negligible. Transactions and financial products providing alternate to interest-based pricing have experienced unprecedented growth and the present growth rate of 15% is considered highest in the international financial markets.[105] The demand of securities based on the principles of Islamic Finance is constantly increasing. For instance, after Pakistan amended its corporate law and allowed the listed companies to issue redeemable capital that is not based on interest, the market was flooded by the successful issuance of such debt securities, and the trend continues.[106]

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[104] This expression literally means the "doer" and conveys a combined meaning as may be understood of "the chairman and the chief executive."

[105] This fact is evidence by establishing Islamic finance departments or spun-offs by the leading international financial institutions, such as Citigroup, ABN AMRO, HSBC etc. So much so that the regulation of Islamic finance is seriously formalized by US regulators. *See* Jay Collins, *The Road Ahead for Islamic Finance*, *in* INTEGRATING ISLAMIC FINANCE IN THE MAINSTREAM: REGULATION, STANDARDIZATION AND TRANSPARENCY (Har. Law. Sch. Islamic Finance Project ed.) (forthcoming Fall 2006) (manuscript on file with author).

[106] The debt securities in Pakistan are known as "Term Finance Certificates" and are issued in terms of Section 120 of the Companies Ordinance, 1984.

To date, not only that such customary laws are deeply entrenched and strongly adhered to in the transition economies but also that their statutory and judicial recognition continues in the prevalent legal system.

In respect of the securities regulation in Pakistan, customary transactions exist at the stock exchanges. To provide an example, *badla* transaction is considered customary at almost all the stock exchanges in Pakistan and India. A *badla* transaction is a carry-forward transaction with easy access to finance at the fluctuating market, and with easy settlement procedure.[107] Efforts to replace the *badla* transaction were strongly resented in Pakistan and reportedly resulted replacement of the Chairman of Pakistan SEC in January 2006 for apparently entangling with lobby of brokers[108] and insisting on new Continuous Financing System Regulation to eliminate the carry-over transaction.[109] This establishes that the customary preferences could be deeply entrenched in emerging securities markets, and also that the strong interest groups exist to lobby against the reforms. The issue of interest groups is further discussed below.[110]

The scholars on corporate governance and transition economies, however, have not discussed the role of customary law in defining corporate governance regime for the emerging economies. Specifically, the analysis is missing as to whether corporate governance reforms are likely to conflict with existing customary law in the transition economies; and, if so, whether the customary laws are likely to persist. The scholarship does not shed light on whether the customary law plays a significant role in shaping corporate behavior and ownership structure in transition economies such as India, Bangladesh, Pakistan, and the Middle-Eastern countries. Future studies examining

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[107] *See generally* The State Bank of Pakistan, Annual Report (Capital Market), *available at* http://www.sbp.gov.pk/reports/annual/arFY01/chap7.pdf (outlining the *badla* transaction in Pakistan stock markets); *See also* India Info Online, the *Badla* System, *available at* http://www.indiainfoline.com/bisc/badl.html (providing definition of the badla transactions).
[108] *See* Business and Finance Review, Did Tariq Hassan Deserve it?, *available at* http://www.jang.com.pk/thenews/jan2006-weekly/busrev-16-01-2006/p5.htm (reporting the Chairman's removal and its possible reasons).
[109] *See* The Securities and Exchange Commission of Pakistan, Chairman's Message, *available at* http://www.secp.gov.pk/ChairmanMessage.htm (outlining the measures taken by the Pakistan SEC).
[110] *See also infra* Part III (C) below.

customary law in the context of capital market growth will inform the scholarly debate highlighting the ignored aspects of the transition economies.

To coexist with the customary law, the modern reforms should take into account the customary law in such a way that the regulatory structure is built with due recognition of it. The process of removing any inconsistencies, if found, between the substantive rights and the customary laws, should be staggered and achieved gradually. Further discussion in this regard is also set out below.[111]

[111] *See also infra* Part II below.

II. CONVERGENCE OF CORPORATE GOVERNANCE AND EMERGING CAPITAL AND SECURITIES MARKETS[112]

For transition economies, there is a desire to catch up with the western standards, leading the wholesale transfer of commercial laws to the transition economies.[113] Convergence of this nature limits corporate evolution.[114] Reforming corporate governance is a matter of comparative institutional analysis.[115] Indiscriminate mixing of legal rules may result in a dysfunctional or unbalanced system lacking certainty. The results are likely to be worse if an ineffective rule is borrowed from any internationally recognized standards.[116] The scholars have expressed serious doubt for the success of transplanted reforms without developing "complimentary institutions"[117] or "institutions."[118] However, some scholars recommended selective incorporation of foreign regulation into one country's law for the possibility of offering an economical and efficient means of transforming the legal structure to attract foreign investment.[119]

Although formal convergence is likely to face several obstacles, functional convergence is achievable through international securities markets, as seen when a foreign firm migrate to the U.S. equity markets.[120] As a general rule, however, the mere transplantation of laws to transition economies may not accomplish the goals of developing strong capital and securities markets if the government continues to maintain a major role in the economic decision-making of the private sector.[121]

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[112] *See also infra* Part III below.
[113] Pistor et al., *supra* note 28, at 327.
[114] Coffee, *supra* note 4, at 646.
[115] Paredes, *supra* note 1, at 1155.
[116] Cally Jordan, *The Conundrum of Corporate Governance*, 30 BROOK. J. INT'L L. 983, 984 (2005).
[117] Gilson, *supra* note 3.
[118] Paredes, *supra* note 1.
[119] Jackson, *The Selective Incorporation of Foreign Legal Systems to Promote Nepal as an International Financial Service Sector*, (Working Paper No. 146600) *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=146600.
[120] Coffee, *supra* note 4, at 650.
[121] John C. Coffee, Jr., *The Rise Of Dispersed Ownership: The Roles Of Law And The State In The Separation Of Ownership And Control*, 111 Yale L.J. 1, 81 (2001).

A. Convergence and Legal Origins

A dominant family-based concentrated ownership structure in the transition economies is not likely to help development of deep equity markets, for it promotes lack of participation in the capital and securities markets. To achieve otherwise, an eventual recourse to the separation of ownership and control appears inevitable for the emerging economies. However, the customary structure, as discussed above, may resist separation of ownership and control. For ensuring smooth transition, a gradual approach will be the best way forward. Because, a customary norm that has attained social level of acceptance equal to the existing norm may replace the existing norm.[122] So, gradual, but firmly enforced, measures will avoid strong repercussion in the form of market retaliation against an unfamiliar norm.

Until the Berle & Means model—of separation of ownership and control—is achieved, the transition economies in Pakistan and India may benefit from the countries having similar family structures to make the functioning of the capital and securities markets more transparent and efficiently regulated. Simultaneously, other steps such as ensuring effective availability of substantive rights, improving regulatory measures, facilitating intermediaries and complementaries, gradual increase in minority rights and remedies may be gradually taken. Upon achieving the satisfactory level, incentives[123] for dispersing ownership and separation of ownership and control would help smooth transition. Any compulsory policy for dispersing ownership and separating ownership and control will give rise to constitutional litigation, for instance in Pakistan, Bangladesh and India, and will quite likely be successful in view of the available constitutional guarantees and traditions.

Like the U.S., many transition economies share common law background, with various features of civil law traditions. Despite this, many economies do not have the Anglo-American dispersed ownership structure, but rather a concentrated corporate ownership structure, like those in developed civil law countries. While the securities market in such

[122] WATSON, *supra* note 101, at 93.
[123] The incentives may include tax relief and relaxed debt-equity ratio for obtaining debt-financing.

economies might develop like the Anglo-American model in the long run, as long as the current ownership structure persists, an analytical recourse to the current corporate governance regimes in France, Germany and Japan appears advisable—on account of the resembling structures of concentrated ownership. As such, scholars have suggested that the transition economies would be better served if they benefit from the corporate governance systems of Germany and Japan.[124] To the contrary, the transition economies borrow heavily from the countries of common law origin.[125]

Notwithstanding the fact that countries with common law origin were rated higher than countries of civil law origin in providing safeguards against related party transactions and for "predict[ing] stock market development,"[126] a comparative recourse to the civil law countries appears beneficial for the transition economies. One of the reasons is for such recourse is to be able to identify the real problem and look for any similarities in other countries. For instance, issues of corporate governance related to the concentration of ownership may be resolved with an analytical lesson from the other jurisdictions having resembling ownership structures. Choosing jurisdictions for finding a short-cut legal solution may amount to taking wrong medication for a different symptom. As noted recently, shareholder and creditor rights in the emerging markets do not develop as a result of a country's historical association with a particular legal origin.[127] At times, the experts advising such reforms incorporate provisions from the law of a particular origin or a country.[128]

[124] Shleifer et al., *supra* note 32, at 738.
[125] *See*, *e.g.*, SECURITIES AND EXCHANGE COMMISSION OF PAKISTAN, MANUAL OF CORPORATE GOVERNANCE, 1 (2002). The Securities and Exchange Commission of Pakistan acknowledged that its Code of Corporate Governance "draws upon the experiences of…countries with a common law tradition" and expressly referred to reports and recommendations from the U.K. and South Africa.
[126] Djankov et al., *supra* note 12, at 35-36; Rafael La Porta, et al., *supra* note 19; *See also* Shleifer et al., *supra* note 32, at 771. (Arguing that the corporate governance systems of the United States, Japan, and Germany are equally good because they not only survived but also the economies of these countries prospered).
[127] Pistor, *supra* note 99, at 85.
[128] *Id.* at 93. (In Pakistan, for instance, the advisers to the Government of Pakistan are more likely to carve out a proposed legislation from the array of similar legislation from various countries that are available online).

However, sharp distinctions between the common law and civil law no longer exist. The countries, once having a specific legal origin, now share the traditions from their counterpart. In this way, the distinctions that once existed in history have largely diminished over the time. Put simply, the transition economies may either be part of commonwealth, and not common law countries, as apposed to belonging to a group of imperialist countries, which once were known as civil law countries. A blanket denomination of civil law and common law countries does not accurately convey the meanings for the present, but would make sense if used for the ease of reference to identify the historical perspective. Therefore, substantive rights for protecting minorities and investors in general do not necessarily emanate from the legal origins, and both the concepts exist independent of each other.

A study finds the legal rules and their enforcement for investor protection to be higher in the common-law traditions.[129] Another study has found a correlation between stock market development and the countries' legal origin.[130] As discussed above, regarding the diminishing distinctions of common law versus civil law, it is unlikely that such distinctions could provide any assistance to improving our understanding of the transition economies. The laws in the transition economies are less influenced by the legal origins but are framed more on the basis of local needs and international relations.[131] A recent work has confirmed the nexus of international relation with the legal development in corporate governance.[132] Convenient access to the modern legislation internationally appears to be the current driving force in the transition economies. Before advancement

[129] La Porta et al., *supra* note 19, at 1151.
[130] Stulz & Williamson, *supra* note 32, at 316.
[131] For instance, the laws in Pakistan draw on Pakistan's commitment to the World Trade Organization and other international commitments, including treaties. Foreign investors and international development organizations and lenders also advise on framing legislation, and often pressurize the transition economies to pass legislation on their suggested format.
[132] Jeffrey N. Gordon, *An International Relations Perspective on the Convergence of Corporate Governance: German Shareholder Capitalism and the European Union, 1990-2000*, (Har. Law Sch. Program on Corp. Governance, Discussion Paper No. 406 of 2003) *available at* http://www.law.harvard.edu/programs/olin_center/corporate_governance/papers/No406.03.Gordon.pdf). *See also* The International Relations Wedge in the Corporate Governance Debate, CONVERGENCE AND PERSISTENCE IN CORPORATE GOVERNANCE, 161-209 (Jeffrey N. Gordon and Mark J. Roe eds., Cambridge University Press (2005).

of informational technology, such access was limited to conventional sources, and the choices were limited to the familiar legislation from the imperialist origin.

Besides irrelevance of legal origins to the transition economies, converging to the U.S. model of corporate governance would mean adopting the shareholders' model of maximizing the shareholders' wealth.[133] However, in a concentrated corporate ownership structure, like in most of the transition economies, maximizing shareholders' interest would result in enrichment of fewer people and would adversely affect the market development.[134] The shareholder's model, therefore, may not be workable for achieving "thick and deep equity markets" in the emerging markets. As noted below in the concluding remarks, political drive to alleviate poverty coupled with the peer-pressure for corporate philanthropy, initiatives for social welfare are expected of the successful firms in countries like Pakistan. In addition, many laws require firms to contribute to the employees' provident, benevolent and workers' welfare funds in addition to subjecting the corporate earnings to *zakat*.[135] Therefore, to coin a new expression, "socially responsible shareholders' model" appears more likely to be the dominant corporate model for many years to come. Furthermore, in the future, it would be quite logical to expect a mandatory corporate social responsibility regime to be a part of corporate governance regime in the transition economies.

The likely role of a corporation in social development in the transition economy does not coincide with the Anglo-American model. Therefore, a strict convergence in the emerging economies is not likely to be possible, despite strong international pressures.

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[133] *See generally* Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2001).

[134] Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. PA. L. REV. 2063, 2064-67, 2080 (arguing that in concentrated form of corporate ownership the shareholders primacy could diminish GNP by resulting into weak competition and monopolistic tendencies)

[135] *Zakat*: An Islamic religious obligation to annually pay 2.5% of the income for charitable purposes. This was made applicable to corporation in Pakistan in 1980.

B. Convergence and "Law Matters"

The pressure for reforming the laws in the emerging markets mainly stems from an axiom that "defects in law will increase the cost of capital and reduce its availability."[136] Also, since "markets are as deep as their legal foundations,"[137] the emerging economies strive to improve the quality of their laws, particularly the corporate and securities laws. For emerging markets, dithering to choose the mandatory or enabling corporate law, the scholars suggested mandatory corporate law to be more appropriate for the countries in transition, and that U.S.-style shareholder primacy to be inappropriate for such countries.[138]

Although disagreeing with the universal applicability of the "law matters thesis," its significance has been considered relevant for the transition economies.[139] However, some scholars have convincingly argued that law alone is not relevant for developing strong and deep securities markets in the transition economies and without the help of surrounding private institution the task might not be possible.[140] Other arguments regard "society's social and political organization" to be crucial, in addition to the suggested institutions, for creation of public firms and a deep securities market[141] and to have more room for private action.[142]

As for the "law matters thesis," its essence "is about strong shareholder property rights, as reflected in the control that shareholders are allocated over the enterprise and the legal limits that constrain managerial and directorial discretion, all pointing in the direction of ensuring that shareholders do not have their wealth expropriated."[143] The "law matters

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136 Bernard S. Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1914 (1996).
137 Bratton & McCahery, *supra* note 33, at 296.
138 Paredes, *supra* note 1, at 1156.
139 Mark. J. Roe, *Corporate Law's Limits*, 31 J. LEGAL STUD. 233, 269 (2002).
140 *See* Paredes, *supra* note 1.
141 Mark. J. Roe, *Political Preconditions to Separating Ownership from Corporate Control*, 53 STAN. L. REV. 539, 601.
142 *See* Coffee, *supra* note 11, at 1829.
143 Troy A. Paredes, *The Importance of Corporate Law: Some Thoughts on Developing Equity Markets in Developing Economies*, TRANSNAT'L LAW. (forthcoming 2006) (manuscript is on file with author).

thesis," therefore, suggests that minority shareholders will emerge pursuant to laws safeguarding their property rights. However, the potential shareholders may need more than protective laws. A legal framework encouraging entrepreneurs to raise capital from the securities market is more important. That is, a well-conceived combination of foreign investment strategy and modernization of customary law will better serve minority shareholders.

Accordingly, indigenously developed legal framework that takes into consideration main concerns of investor protections, effective accountability, and transparency and ensuring effective enforcement will survive the criticism against convergence. The scholars do not approve of transplanting laws alone; they seem to suggest transplanting institutions too. This form of convergence is workable only if the emerging capital and securities markets start moving toward "functional" or "stealth" convergence. Functional adaptation will provide a hint that the markets are ready for the formal transplant of laws and institutions to the extent of functional convergence. At this juncture, the formal rules to provide back-up for the functional convergence should keep in view the social and cultural considerations, as discussed above.

Put differently, despite supply of foreign legal rules, the legal reforms in transition economies tend to respond to the legal change rather than leading it,[144] or a gradual policy approach.[145] Countries implementing economic reforms gradually coupled with "legal and other institutional reforms have developed more effective institutions than those that pursued a radical reform agenda."[146] Therefore, improving the law gradually and keeping in view the market development and response will be more beneficial to the emerging economies.

[144] Pistor, *supra* note 99, at 60.
[145] *Id.* at 90.
[146] *Id.* at 93.

C. Transplanting Self-Enforcement

The salient features of the self-enforcing model devised for the transition economies include: enforcement through actions by shareholders, directors and managers; greater protection for outside shareholders; reliance on procedural protections; the use of bright line rules that can be enforced for their violation, in contrast to the standards that are generally not enforceable; and strong legal remedies.[147] Some scholars have endorsed "self-enforcing" remedies in the wake of inadequate judicial performance in the transition economies.[148] Self-regulation may receive good result in transition economies, even in the absence of optimal legislation.[149]

However, the self-enforcing model may not be relevant for those transition economies that not only have deficient enforcement mechanisms—despite effective regulatory rules on the book—but also less literate common shareholders. In this scenario, more emphasis on effective enforcement through an efficient regulator that safeguards the shareholders appears more workable.

In sum, successful adaptation of legal reform to local condition may depend on the socio-economic conditions of the transition economies, but the success of even apparently familiar legal reforms cannot be predicted with confidence.[150] However, early success of such reforms appears one of the important considerations to avoid lack of public support.[151]

Additionally, there are precursors to corporate governance reforms in the emerging markets. First, based on the relevant international standards, revision of the existing laws

[147] Black & Kraakman, *supra* note 136, at 1916. *See also* Katharina Pistor, *The Standardization of Law and Its Effect on Developing Economies*, 50 AM. J. COMP. L. 97 (2002) (discussing legal rules and legal systems).
[148] John C. Coffee, Jr., *Privatization and Corporate Governance: The Lessons from Securities Market Failure*, 25 J. Corp. L. 1, 38 (1999).
[149] Coffee, *supra* note 121, at 81.
[150] Pistor et al., *supra* note 28, at 356.
[151] Paredes, *supra* note 1.

that relate to the corporate governance[152] can be made. Second, "complimentary institutions" or "institutions" that have been regarded as essential for the successful securities markets may be developed. Third, based on a well-researched recognition of the customary laws, the above two precursors may be made consistent with such laws.

[152] Laws relating to corporate governance may be classified as primary and secondary. In the paper, laws directly relating to the organization, conduct and procedures and the securities regulation could be termed as the primary corporate governance laws and those requiring corporate responsibilities for other subject matters could be called secondary. *See generally* Ali Adnan Ibrahim, *Corporate Governance in Pakistan—Analysis of Current Challenges and Synopses for Future Reforms*, 6 WASH. U GLOBAL STUD. L. REV. (forthcoming Fall 2006), *available at* http://ravi.lums.edu.pk/cmer/Conference2005/images/Ali%20Adnan%20Ibrahim%20paper.pdf, (discussing the laws indirectly related to corporate governance).

III. INTERNATIONAL SECURITIES MARKETS AND REGULATION OF EMERGING SECURITIES MARKETS

A. Financial Regulation: Objectives and Emerging Securities Markets

Objectives for financial services regulation include protection of public investor, elimination of externalities from the failure of intermediaries, redistributive policies, equitable norms and consideration of political economy,[153] and "elimination of financial crime and international terrorism."[154] There are three fields of financial regulation: corporate governance, securities regulation, and regulation of financial institutions.[155]

As for the emerging securities markets, a combination of market institutions and regulations ensure effective corporate governance.[156] Well-regulated stock exchanges will make raising finances convenient. This can lead to economic growth, without having to deal with the drawbacks associated with the foreign aid and borrowing.[157] In addition to the legislative and regulatory measure, the stock exchanges, as frontline regulators, may improve corporate governance practices by protecting investors and maintaining the integrity of securities market.[158]

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[153] Howell E. Jackson, *Regulation in Multisectored Financial Services Industry*, 77 Wash. U.L.Q. 319, 332-339 (1999).

[154] This has been added to the list recently. *See* Jackson, *supra* note 7, at 6-7.

[155] Howell E. Jackson, *Centralization, Competition and Privatization in Financial Regulation*, 2 Theoretical Inquiries L. 649, 649 (2001).

[156] Bernard S. Black et al., *Final Report and Legal Reform Recommendations to the Ministry of Justice of the Republic of Korea*, 26 J. CORP. L. 546, 546 (2001).

[157] William C. Philbrick, *The Paving of Wall Street in Eastern Europe: Establishing Infrastructure for Stock Markets in the Formerly Centrally Planned Economies*, 25 LAW & POL'Y INT'L BUS. 565 (1994).

[158] Robert Todd Lang et al., *Special Study on Market Structure, Listing Standards, and Corporate Governance*, 57 BUS. LAW. 1487, 1558 (2002). (The author suggests that the stock exchanges should do this with the help of the stakeholders).

Issuers Choice

In the post-globalization scenario, with lowered barriers to capital and instantaneous information flow, securities markets compete and issuers chose the market on which to list their securities,[159] and would be subject to one set of liability standards and enforcement remedies.[160] Taking advantage of this trend, issuers, particularly from transition economies, may raise equity capital from the market of their choice.[161] However, the issuers form the developed markets may not find it advantageous to chose the emerging securities markets. Availability of "viable"[162] and internationally competitive and securities markets in the transition economies is likely to change the trend.

Issuers opt for international listing for financial reason of raising capital at a lower cost and higher valuation for their business on account of foreign identity.[163] However, due to lower exchange rates, it appears difficult for companies in the transition economies to pay dividends in a currency of a higher value. For instance, the dollar amount is always going to be higher in most of the transition economies when it comes to payment of dividend to the shareholders in the international markets. With the expectancy of profit always likely to be lower, the issuers from most of the emerging securities markets may not have the advantage of raising financial capital at the developed markets.

In the absence of sufficient legal and regulatory infrastructure[164] the transition economies cannot offer sophisticated and internationally competitive securities law. With the lack of competitiveness of the emerging securities markets, the foreign investor from the

[159] Coffee, *supra* note 11, at 1759-60.
[160] Hal S. Scott, *Internationalization of Primary Public Securities Markets*, 63 SMU LAW & CONTEMP. PROBS. 71, 71 (2000). (Against the sufficient investor demand, recommending Optimal Standardized Issuance to reduce the cost of issuance and promote healthy competition in the primary market).
[161] Coffee, *supra* note 11, at 1759-60.
[162] Coffee, *supra* note 148, at 38. (Arguing, *inter alia*, that viable markets will not develop in the absence of a workable regulatory mechanism).
[163] Amir N. Licht, *Genie in a Bottle? Assessing Managerial Opportunism in International Securities Transactions*, 2000 COLUM. BUS. L. REV. 51, 54 (2000).
[164] Including the use of technology for more optimal arrangements at the level of primary market. *See generally* Scott, *supra* note 160, at 104.

developed economies might stay home,[165] instead of choosing to list on emerging securities markets. On the other hand, the lack of international competitiveness may prompt the issuers from the emerging securities markets to opt out of their jurisdictions in favor of any developed market, making it more difficult for the emerging securities markets to develop the lacking competitiveness.

In short, it appears imperative for the economies of transition that their legal framework, in particular the corporate laws, serve the objectives similar to its counterpart in developed economies. Essentially, it is necessary to set out governance rules that not only recognize and implement the customary law, but also maximize the value of investment[166] and provide minority protection.[167] Or, put differently, blending the customary law and the substantive rights for minority and investor protection into the corporate governance regime would be beneficial for the emerging markets. Unlike the laws that are not effectively enforced for the reasons of inconsistencies with the customary law, a regime combining the substantive rights and the customary law would be easily enforceable because ensuring compliance with such regime would be easier. In this way, a better form of corporate governance would become economical and cost-efficient not only for the transition economies but also for the firms subject to such regime.

Regulatory Competition

Internationalized securities markets have made it easier to trade securities around the world[168] and listing in multiple legal regimes.[169] With the disclosed information becoming available in multiple jurisdictions, each disclosure has a different impact in

[165] Frederick Tung, *Lost in Translation: From U.S. Corporate Charter Competition to Issuer Choice in International Securities Regulation*, 39 Ga. L. Rev. 525, 532 (2005). (Arguing that such lack results in indeterminacy of the legal system).
[166] Black & Kraakman, *supra* note 136, at 1913. (Suggesting that the corporate laws for the emerging markets must be drafted afresh to work within the available infrastructure).
[167] Coffee, *supra* note 148, at 39.
[168] Amir N. Licht, *Regulatory Arbitrage for Real: International Securities Regulation in a World of Interacting Securities Markets*, 38 VA. J. INT'L L. 563, 564 (1998).
[169] *Id.* at 566-7.

different jurisdictions, introducing the possibility for the listed entity to migrate to the lower regulatory jurisdiction,[170] or a race to the bottom. However, regarding foreign corporations abiding by the U.S. laws when they gain access to the U.S. capital markets, the evidence suggests that the corporations opted for the higher-standard regime, or a race to the top.[171] Thus, the migrating entities exert a downward pressure on jurisdictions concerned.[172] As found by scholars, the entities may not necessarily migrate, but rather play one jurisdiction against the other in an effort to have the most suitable conditions, known as regulatory arbitrage. Regulatory arbitrage, however, is not always successful, and the jurisdictions concerned may enhance the regulatory regime.[173] Also, many of the securities markets in transition have not experienced these dynamics of internationalized markets.

For regulatory competition to occur, there must be some degree of choice available to an entity to govern its activities. Additionally, the entity must also be able to move between the eligible jurisdictional regimes without incurring excessive costs. The relevant governments should also have the inclination of changing the rules in response to the choices of selection that the entity makes.[174] The issuer choice does not generally lead to a race to the bottom. On the contrary, it worked in the opposite direction, toward higher disclosure standards.[175] Evolving linkages across the securities markets, like in E.U. member countries, may reduce any need for issuer choice.[176] This discussion may, however, have a different conclusion with regard to the emerging securities markets.[177]

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[170] *Id.* at 567.
[171] Howell E. Jackson, *Regulatory Competition in the International Securities Market: Evidence from Europe in 1999*, 56 Bus. Law. 653, 655 (2001).
[172] Licht, *supra* note 168, at 567. *See also* Coffee, *supra* note 4, at 705.
[173] *See* Licht. (Arguing that due to the economic interdependence in the multiple listings, the states may have to formalize their internal cooperation, probably through an institution, at 637).
[174] Jackson, *supra* note 171, at 658-9.
[175] *Id.* at 691.
[176] *Id.*
[177] As a notable scholar suggested, the Nepalese model may be an isolated case where, for instance, the Swiss firms will have a choice of familiar or higher regime. That is to say, to have Swiss law as the governing law. *See* Jackson, *supra* note 119.

The increasing level of competition in international securities markets is now forcing the stock exchanges to transform.[178] Toward this end, demutualization and international mergers and alliances are the popular trends.[179] The pressurized exchanges are applying various survival techniques including "dual listing,"[180] and are exerting further pressure for structural reforms in the national securities regimes.[181] As being forced by the competition, fragmentation is a current phenomenon in the foreign and U.S. markets, along with the stock exchanges demutualization.[182]

Regulatory Intensity and Public Benefit

In general, regulatory intensity responds to the prevailing markets practices. It is difficult to measure the most desirable regulatory intensity in a particular country due to the variety of cross-country variables. Clearly, different levels of regulatory intensity exist in different jurisdictions.[183] Increased regulatory intensity is generally beneficial to society, but carries a risk of its being counterproductive in some cases.[184] Overregulation is also likely to make raising capital costly.[185] It is generally difficult, and complex, to measure the public benefits of financial regulation.[186] As for the transition economies, a bare-minimum of regulatory intensity may direct and allow development in a safe and effective manner. A basic standardization in this regard is likely to be helpful. Such

[178] Amir N. Licht, *Stock Exchanges Mobility, Unilateral Recognition, and the Privatization of Securities Regulation*, 41 VA. J. INT'L L. 583, 584 (2001).
[179] *Id.* at 587.
[180] Amir N. Licht, *David's Dilemma: A Case Study of Securities Regulation in a Small Open Market*, 2 THEORETICAL INQUIRIES L. 673, 706 (2001).
[181] Licht, *supra* note 178, at 626-27.
[182] Robert Todd Lang et al., *Special Study on Market Structure, Listing Standards, and Corporate Governance*, 57 BUS. LAW. 1487, 1492-93 (2002).
[183] Jackson, *supra* note 7, at 2-3.
[184] *Id.* at 3.
[185] Black et al., *supra* note 156, at 546. In post Sarbanes-Oxley period, various companies have unlisted themselves and lesser companies are going public due the increased costs of disclosures and auditing. An estimate of increase in costs is 4%. This could be an example of over-regulation and increased costs.
[186] Jackson, *supra* note 7, at 3-4 and 31. (Suggesting, for measuring the public benefits of financial regulation, for instance, examination of the banking and securities regulation, p. 32).

standardization may include the principles and objectives proposed by international organizations.[187]

Regulatory structures are influenced by various considerations that vary across jurisdictions.[188] The U.S. and the U.K. share various organizational traditions, including legal and disclosure-based securities regulation, and financial regulation in general.[189] Despite this, there is a substantial divergence between the regulatory structures of both the countries,[190] with regulatory intensity in the U.K. to be substantially lower than the U.S.[191]

B. Regulatory Convergence

Unlike corporate laws, securities laws are more likely to functionally converge, or, in other words, by way of "stealth convergence."[192] Such convergence is generally achieved by modifications (or up-gradation) in the listing regulations by the front-line regulators. Amendments in corporate laws is a time consuming process, and is less influenced by the regulatory competition and issuers' choice. As for convergence at the level of securities regulation, this phenomenon has some similarity in the emerging securities markets where the publicly traded firms (including the listed foreign investing vehicles) have been required by the stock exchanges to comply with the codes of corporate governance, including following both new listing rules as well as the applicable securities regulation.[193] Because the functional or stealth convergence may be a result of

[187] For instance, OECD's Principles of Corporate Governance, IOSCO's Objectives and Principles of Securities Regulation.
[188] Howell E. Jackson, *An American Perspective on the U.K. Financial Services Authority: Politics, Goals & Regulatory Intensity*, 3 (Har. Law Sch. Program on Corp. Governance, Discussion Paper No. 522 of 2005), available at http://www.law.harvard.edu/programs/olin_center/papers/pdf/Jackson_522.pdf.
[189] *Id.* at 2.
[190] *Id.*
[191] *Id.* at 43.
[192] Coffee, *supra* note 4, at 705.
[193] The Securities and Exchange Commission of Pakistan directed the stock exchanges to incorporate the Code of Corporate Governance in their listing rules. *See* The Coe of Corporate Governance, *available at* http://www.secp.gov.pk/news/code_corporate(revised).htm. Introducing codes of corporate governance as part of the listing rules is an international trend in the stock exchanges. *See generally* Licht, *supra* note 180, at 707.

market efficiency, the emerging securities markets may have to rely more on formal convergence in order for them to achieve efficiency. However, the form of convergence that can promise efficiency to the emerging securities markets is an issue that remains largely unanswered. As discussed above, the market response will provide a good indication whether and when to introduce any modern reforms.

Although the developing countries may learn from the experiences of more advanced countries, they should be careful in importing regulatory structures because of the variation in the underlying differences. Such differences could be of scale, composition and sophistication of the financial services industry, regulatory objectives, levels of enforcement intensity, and levels of lawlessness of population.[194] The discussion of regulatory convergence is simplified if it implies that the adopted legal rules would be enforced optimally. Optimal enforcement would explain if there is *de facto* regulatory convergence, in addition to *de jure* convergence.[195] Accordingly, the evidence of convergence would be more informative if it also includes the intensity with which a transplanted rule is being enforced.[196]

Despite benefits of international comparisons, there are numerous constraints on the regulatory harmonization.[197] In general, the corporate governance regime of any country affects the form and substance of its securities regulation.[198] Although corporate laws are more likely to converge through harmonization, the securities laws are not.[199] Effective securities regulation may make up the existing deficiency in corporate laws.[200] However, some scholars have predicted convergence at the level of securities regulation.[201] The "piggybacking" strategy helps the issuer to move to a better corporate governance regime

[194] Jackson, *supra* note 7, at 12-14.
[195] *Id.* at 30-31.
[196] *Id.* at 31.
[197] Jackson, *supra* note 188, at 3.
[198] Amir N. Licht, *International Diversity in Securities Regulation: Roadblocks on the Way to Convergence*, 20 CARDOZO L. REV. 227, 230 (1998).
[199] *Id.* at 285. (Treating corporate law to be a part of private law and securities regulation to be a part of public laws and arguing that due the public character, the securities regulations are less likely to converge).
[200] Licht, *supra* note 198, at 230.
[201] *See* Coffee, *supra* note 4.

by listing its shares on a foreign market.[202] Therefore, cross-listing may be a way to achieving international convergence toward the most desirable regimes,[203] despite the fact that cross-listing may not be a quick solution to improving the corporate governance—the effective measure in this regard should come from the home country.[204] However, cross-listing could be an effective and *interim* substitute for convergence among different countries.

Cultures and Customs in Regulatory Convergence

"[A] systematic cross-cultural theory for corporate governance is urgently needed."[205] The national cultures play a significant role in the origin and development of the corporate governance systems.[206] The "cultural infrastructure calls on people to seek guidance for conducting their personal life in social interactions in sources other than the law."[207] The foreignness of modern reforms is fundamental and the "cultural value emphases may preserve and perpetuate the imprint of ancient intellectual legacies and historical initial conditions."[208] All the players in the international securities markets, including stock exchanges and issuers, understand the overriding factors of distances and cultural proximities and make their moves accordingly.[209] The cultures and informational distances matter even for the cross-listing of securities.[210] Some scholars have argued that "[r]eligion is a convenient proxy for culture…[but it] fails to capture the richness of cultural differences."[211] "Without considering the countries' cultural regional

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[202] Licht, *supra* note 180, at 679.
[203] Amir N. Licht, *Legal Plug-Ins: Cultural Distance, Cross-Listing, and Corporate Governance Reform*, 22 BERKELEY J. INT'L L. 195, 197 (2004).
[204] Amir N. Licht, *Cross-Listing and Corporate Governance: Bonding or Avoiding*, 4 CHI. J. INT'L L. 141, 163 (2003).
[205] Licht, *supra* note 5, at 203.
[206] *Id.*
[207] Licht, *supra* note 203, at 230-31.
[208] *Id.* at 232.
[209] Licht, *supra* note 204, at 163.
[210] Licht, *supra* note 203, at 239.
[211] Licht, *supra* note 32, at 231. (This analysis, however, does not take into consideration weather the reverse would be true, that is, religion shaping the culture and not *vice versa*).

affiliation, the legal family classification may yield inaccurate depictions of global pattern in corporate governance regimes."[212]

The available literature does not distinguish between culture and the customary law and may include customary law in its generality. The absence of such distinction may be the result of reliance upon scholarly works in the general areas of social sciences. A distinction, however, exists in jurisprudence.[213]

Convergence vis-à-vis Specialization

It is likely that different markets specialize in trading securities of a particular type of firms.[214] This phenomenon may be developed in the emerging securities markets where firms eyeing for particular incentives invest in specialized sectors. Accordingly, given the nature of incentives in various sectors by the transition economies, the emerging securities markets may develop specialized trading expertise in the securities of a particular sector or industry. As discussed below, such specialization may be consistent with their foreign investment policy.

Convergence and Regionalization

The prediction of specialized stock exchanges serving different clienteles of listed corporations[215] may also occur at the regional level in the emerging securities markets. The divergence of investment opportunities in the transition economies may lead to competition to attract foreign investment. Depending on the success of the foreign investment policies in specific industrial sectors, regional securities markets may develop

[212] *Id.* at 247.
[213] *See generally* THE PRINCIPLES OF SOCIAL ORDER (Kenneth I. Winston ed., 2001).
[214] Coffee, *supra* note 4, at 652.
[215] Coffee, *supra* note 11, at 1830.

to attract listing in the specialized sectors.[216] However, empirical evidence in this regard remains to be explored.

The law of one price provides another possibility for the emerging securities markets to have integrated arrangements.[217] Before achieving regionalization or integration, the emerging securities markets may consider harmonization, multi-jurisdictional disclosure system and an offshore free-zone to increase their competitiveness.[218]

Scholars have recommended regional cooperation among the emerging securities markets, focusing specifically on Latin America,[219] Sub-Saharan Africa[220] and Eastern Europe.[221] Likewise, the Middle-Eastern economies[222] are on their way of a regional

[216] One form of regionalized securities market is a regional homogeneous market for the securities based on the principles of Islamic Finance. The industry of Islamic Finance is growing at the rate of 15% and is reaching US$ 400 billion. A specialized regional stock exchange will provide a platform for further growth. *See* Ali Adnan Ibrahim, *Islamic Financial Services Industry: Corporate Governance and Need for a Regional Securities Market*, *in* INTEGRATING ISLAMIC FINANCE IN THE MAINSTREAM: REGULATION, STANDARDIZATION AND TRANSPARENCY (Har. Law. Sch. Islamic Finance Project ed.) (forthcoming Fall 2006) (manuscript on file with author).

[217] Licht, *supra* note 180, at 687. (Arguing, *inter alia*, that the law of one price curbs arbitrage profits—under-priced buying and overpriced selling).

[218] Scott, *supra* note 160, at 78 and 92. (The author does not consider harmonization and multi-jurisdictional disclosure system viable for international securities market—but recommends establishing offshore free-zone).

[219] Les Riordan, *Three Proposals for a Latin American Stock Exchange, Private Offshore Market, or a Computerized Financial Information Service*, 27 U. MIAMI INTER-AM. L. REV. 585 (1996).

[220] Evelyn Bradley, A regional Stock Exchange: Hope for Sub-Saharan Africa Stock Markets, 8 MSU-DCL J. Int'l L. 305 (1999); *See also* Charles R. P. Pouncy, *Stock Markets in Sub-Saharan Africa: Western Legal Institutions as a Component of the Neo-Colonial Project*, 23 U. PA. J. INT'L ECON. L. 85 (2002) (criticizing this strategy); *See generally* Claire Moore Dickerson, Harmonizing Business Laws in Africa: OHADA Calls the Tune, 44 COLUM. J. TRANSNAT'L L. 17 (2005) (setting out general economic cooperative initiatives in Africa).

[221] Philbrick, *supra* note 157.

[222] These countries are also committed to reforming their capital markets and continue to look for the right guideline for the reforms. For instance, the Director General of "Dubai International Finance Centre" announced the establishment of a "Regional Institute of Corporate Governance to serve at improving the regional securities and financial markets. Dr. Omar Bin Sulaiman maintained:

> Transparency and governance is critical in delivering the knowledge, capital, and skills that will enable the region to diversify its economies away from oil and gas, and to grow the wealth of its people, which will lead to political and social stability. As we raise our corporate governance levels, it will increase trust in the region's financial sector, and contribute to attracting foreign direct investment, as well as encouraging local and regional banks to provide financing to SMEs and entrepreneurs.

securities market. Furthermore, to launch a world-class financial center in the Middle East, Dubai[223] established the Dubai International Financing Center, a free-trade zone with an independent regulatory authority to oversee the activities related to the Center.[224]

In sum, in addition to international sponsorship, a culturally sensitive regulatory framework and regional cooperation will promote the success of securities market in a developing country.[225]

C. Foreign Investment and Emerging Securities Markets

Like other countries in transition, Pakistan remains committed to encouraging foreign investment in its industrial and service sectors, and offers incentives such as fiscal relief, tax havens, and repatriation of profits, original investment and disinvestment proceeds. Eying low costs of production, foreign investors often find such incentives attractive. In return, Pakistan receives employment and trade opportunities.[226] The result is that foreign investment has substantially increased in Pakistan. Most of the investment vehicles are organized as private companies, and in a local-foreign joint venture scenario, as unlisted public companies. However, the number of listed subsidiaries of an off-shore holding entity is small, and such subsidiaries rarely offer any substantial equity.

Although "[c]ountries with worse governance have a smaller fraction of wealth owned by foreign investors because insiders have larger ownership shares in such countries,"[227] the foreign investors organize their corporate vehicles similar to the most dominant, or

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For complete coverage of the above announcement, *see* http://www.ameinfo.com/73238.html (last visited Jan. 14, 2005). *See also* Paul A. Mackey et al., *Internal Securities and Capital Markets*, 39 INT'L LAW. 373, 373 (2005);

[223] Dubai is one of the 5 Emirates of the United Arab Emirates, and is regarded the most attractive for foreign investment in whole of the Middle-East. Dubai appears to stands out as successful experiment of legal transplant. This aspect required further analysis in a separate work.

[224] Mackey et al., *supra* note 222, at 374.

[225] Jason Gottlieb, *Launching the Phnom Penh Stock Exchange, Toward a Legal Framework for Launching a Stock Exchange in an Underdeveloped Country*, 14 COLUM, J. ASIAN L. 235, 275 (2000).

[226] Such opportunities include the provision of raw materials and labor and services contracting.

[227] Stulz, *supra* note 26, at 1624.

culturally consistent, ownership pattern—which is the concentrated one in Pakistan. More problematically, the overwhelming majority of foreign investors follow this pattern.

Despite the increased foreign investment, the economic benefits do not seem to trickle down, but rather remain largely restricted to a small part of the population who are directly involved with the industrial operations of the investment vehicle. One possible reason for the limited role of foreign investment is its limited economic interaction with the local market.

Reforms in Securities Markets and Rent Seeking

Pakistan is not only consistently revising its corporate and securities laws to conform to the international standards but also providing maximum facilities for the foreign investment in all the sectors of its economy. Despite this, Pakistan has yet to achieve the critical mass to turn the securities markets into a significant factor in its economic growth. The existence of "thick and deep equity markets" would require participation by the mainstream of the economy in the equity markets.

Generally, it is not possible to measure the influence of internal and/or external forces that shape the legal reforms.[228] However, foreign investors have been able to negotiate legislative and regulatory protections in the emerging markets. Their influence is also likely to influence the corporate governance reforms. For instance, local investors will not be encouraged to become minority shareholders as long as the corporate governance regime does not guarantee appropriate protection. Since the local investors do not have the adequate clout to outweigh the existing rent-seeking groups, they are less likely to achieve effective protections. However, in the event that foreign investors are encouraged to become minority shareholders in the emerging securities markets, the foreign investors would be able to exert the advantage of their position to negotiate better protections with the governments in the transition economies. The protections, once accorded to the foreign investors for being the minority shareholders, will also be

[228] Pistor, *supra* note 99, at 93.

available to the local investors, and will encourage them to become the minority shareholders. Otherwise, the locals are not likely to secure greater legal protection on vis-à-vis the majority owners, who see active minority to be a threat to their "private benefits of control."

The foreign investors have been able to negotiate lucrative financial and fiscal incentives in a number of emerging markets. For instance, in Pakistan, the foreign investors in energy, infrastructure and telecommunication sectors receive sector-specific incentives. All of them have influenced amendments to the national antitrust law that declares control of one-third of the market share of any services (and good) to be monopoly and, therefore, prohibited and liable to compulsory disinvestment and dilution.[229] Strong local industries have not been able to convince the government for carving out any exception. Tax haven for up to 5 and more years and fixed (as opposed to *pro rata* generaly applicable) stamp duty and registration fee on the financing documents are other incentives enjoyed by such sectoral investors. Particularly in the power and energy sectors, the Independent Power Producers and Oil & Gas Exploring Companies execute Concessions Agreements that list the assurances by the Government of Pakistan in respect of obtaining various governmental permissions from the federal and provincial authorities. Such concessions also include assurances against "change of law" (including any judgment of the court) that may be detrimental to such investors. Upon such happening or loss of concessions, Sovereign Guarantees becomes immediately encashable. In standard government contracts, Pakistan law and courts are nonnegotiable. However, the investment disputes with the Government of Pakistan include out of Pakistan settlement mechanisms, including international arbitration, foreign governing laws and foreign forum. In addition, some foreign investors have also invoked International Center for Settlement of Investment Disputes (ICSID), the award of which is enforceable by the World Bank through its deduction/increase in the aid/debt for/of Pakistan, and for that matter ay other emerging economies.

[229] Although the law has apparently provided a different adjudicating authority for such sectors, but it is common knowledge that such authorities are the ones granting the (licensing) rights to the foreign investors that lead to the market share in excess of the prohibited threshold.

With the support from the developing countries' lenders, the foreign investors enjoy a great leverage in negotiating legislative and administrative protections from the economies in transition. Therefore, unless the international investors are willing to become minority shareholders in the emerging securities markets, the existing family ownerships will likely resist the modernization initiatives.[230] Initiatives to change the status quo are likely to be resisted and lobbied against by the existing interest groups,[231] who would consider themselves better off otherwise. Ensuing rent-seeking tactics may halt the reform initiatives and further delay the expected economic growth. To avoid this stumbling block, persuading the affected constituencies is the most effective way to facilitate smooth implementation of reforms in the transition economies.[232]

A chief concern among foreign investors is the unfamiliarity with the local corporate and securities laws,[233] or the local corporate governance regime. For the foreign investor, familiarity with local laws and their trust on the effective enforcement of such laws is quite important before such investor can implement their investment strategy. Appreciating the concerns and recognizing the global trend,[234] Pakistan began reforming its corporate governance regime. Such reforms are mostly achieved through importing or mixing various models from the developed economies. However, rather than moving toward an internationally competitive securities market, Pakistan is attracting more foreign investment in the industrial and service sectors.[235]

In general, foreign investment contributes to the economic growth in the transition economies, by increasing the number of jobs and trade opportunities. However, mere reliance on foreign investment instead of improving conditions for nurturing the local

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[230] *See generally* Mark J. Roe, *Rents and their Corporate Consequences*, 53 STAN. L. REV. 1463 (2001).
[231] La Porta et al., *supra* note 40, at 512.
[232] Marc I. Steinberg, *Emerging Capital Markets: Proposals and Recommendations for Implementation*, 30 INT'L LAW. 715, 738 (1996).
[233] Jackson, *supra* note 119, at 4. *See also* Ibrahim, *supra* note 152. (Specifying relevant laws that impact corporate governance in Pakistan).
[234] *See generally* CONVERGENCE AND PERSISTENCE IN CORPORATE GOVERNANCE, 1-6 (Jeffrey N. Gordon and Mark J. Roe eds., Cambridge University Press (2005)) (giving brief overview of global trends).
[235] *See generally* The Securities and Exchange Commission of Pakistan, Message of the Chairman, *available at* http://www.secp.gov.pk/ChairmanMessage.htm (last visited Jan. 14, 2006) (outlining a number of measures taken by Pakistan SEC).

industry could have disastrous consequences not only for the local industry but also for the economy in general. Foreign investment should be encouraged primarily to introduce healthy competition, which is beneficial for the local industry. As for the capital and securities markets in the transition economies, well-developed markets become attractive without much effort, and, conversely, under-developed markets do not—no matter how lucrative incentive are offered. Institutions such as customary law coupled with the substantive legal protections, effective enforcement and development of legal and non-legal institutions bring internal strength to the markets; and the markets become attractive for foreign investment. Lack of foreign investment in the securities market in Pakistan indicates that Pakistan's market is not perceived to be developed or ready for the international investors. Such perception could only be set aside if the market is profitable to a larger number of participants locally, rather than to the existing limited number. Such participation is achievable only by allowing customary law to be part and parcel of the corporate governance regime.

Future Considerations for Regulating Emerging Securities Markets

As discussed above, a standard pattern of foreign investment in the transition economies suggests that the foreign investors are more attracted to industrial and related sectors mainly for cost efficiency reasons. In doing so, the foreign investors retain majority control in the investing vehicle and avoid a resisting minority by rarely diluting the ownership interests. More rights and increased protections for the minority, as reiterated recently,[236] may stand inconsistent with the existing business strategy of cost efficiency. Viewing this way, an inverse demand for convergence of the corporate governance regime may partly exist in the transition economies. The convergence to this effect could lead to investment flight to less stringent emerging securities markets, unlike a race to the top in the developed economies.

Continued lower standards of corporate governance appears to increase the quantum of industrial foreign investment while higher standards of corporate governance, ironically,

[236] *See generally* Djankov et al., *supra* note 8.

dissuades the foreign investors from diluting their ownership interest in the emerging securities markets. However, it remains to be examined whether the convergence of corporate governance could lead to investment flight to less stringent emerging securities markets.

Ineffective International Initiatives

Reforms suggested by various international organizations[237] and those sponsored by the international lending agencies do not appear to be helping the expansion of the securities markets. The main reason for their lack of efficacy is the unfamiliar origin of the new rules. When a significant number of potential market participants do not understand the new rules and their intent in their common parlance, they are less likely to follow them for lack of understanding. Therefore, an examination of local customs and market practices is pertinent.

As discussed above, achieving a self-reliant market is possible through implementing and, where necessary, modernizing the indigenous customary practices. Increased local participation in the emerging securities markets will be an outcome of the market ensuring protection of investment and culturally consistent and familiar corporate governance regime. Once strengthened by the local participation, foreign investment will turn to the emerging securities markets to tap the potential profits, and not *vice versa*: The market will not be profitable merely by inviting foreign investment to the securities markets.

In the event that the foreign investment in the securities market is found less likely to strengthen the securities market, the transition economies will be left with only the option

[237] Such institutions include: Asia Pacific Corporate Registers Forum (APCRF); Asian Development Bank (ADB); International Finance Corporation (IFC); International Monetary Fund (IMF); International Organization of Securities Commissions (IOSCO); Organization for Economic Co-operation and Development (OECD); South Asian Securities Regulators Forum (SASRF); United Nations Development Fund (UNDP); and World Bank. These institutions are officially designated as "stakeholders" by Securities and Exchange Commission of Pakistan, *available at* http://www.secp.gov.pk/InternationalOrganizationAgencies.htm (last visited Jan. 14, 2006).

of mobilizing the local entrepreneur to the securities market. Although this outcome would be contrary to the expectations and national policies of various emerging markets, but this strategy should be the starting point, rather than the fall back option for failure of foreign investment to provide a kick-off start. Foreign investment will find an emerging securities market attractive if the market is already offering profitable participation. To achieve a level of increased participation, the emerging economies need to focus on the concerns that an ambivalent entrepreneur or local investor may have. Such concerns may adequately be addressed through, among others, modernizing customary law, as discussed above.

CONCLUSIONS

Comparing the corporate evolution in the developed economies with the emerging markets provides us a better insight to the distinct features of the transition economies. Identification of such differences helps devise better strategies for the economies in transition to improve their economic growth.

The forces directing the corporate evolution, for instance, in the U.S. were strikingly different from those that any of the emerging markets might to be facing today. That is, concentration of economic power followed the rise modern corporation, and with this emergence, strong political power of the state looked to regulate the economic strength of the corporation, which it tried to avoid.[238] Thus, corporate governance, particularly, in the U.S. represents a political tussle as suggested by Berle and Means.[239]

On the other hand, corporation in the emerging markets has not become a significant economic power as yet,[240] the political forces in the emerging markets tend to deregulate corporation and offer lucrative incentives, to attract foreign corporations. Corporate governance in the emerging markets is political strategy to attract foreign corporations, for improving economic growth, than to regulate them—which appears the case in the developed economies.

Foreseeing the future of capital markets in the emerging economies, it looks to be somewhat close to what Berle and Means suggested that the survival of the corporate system may rest on spreading its profits on various stakeholders in society, while almost rejecting the shareholders' model.[241] Since the capital and securities markets reforms are part of the poverty alleviation strategy in the emerging economies, it looks more logical

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[238] BERLE & MEANS, *supra* note 41, at 357.
[239] *See* MARK J. ROE, STRONG MANGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE (1994).
[240] But even if it be true, such power remains mostly with the families that own the majority shares, and not with the corporation as such.
[241] BERLE & MEANS, *supra* note 41, at 356.

that the laws of emerging markets require a mandatory participation for social welfare. This governmental strategy is likely to be more aggressive when the emerging markets achieve some level of economic growth as a result of foreign investment. Making the foreign corporations to contribute to the social welfare is quite likely to generate the debate, in future, over sharing of profits with the society vis-à-vis the rights to repatriation.

The development of capital and securities markets for the transition economies mainly rests on the regulatory infrastructure that includes the right law that incorporates the social and cultural practices and establishment of the supporting institutions. Such practices include customary laws that often shape corporate behavior and ownership structures, and are more significant in the economies in transition. As most of the scholarly discussions consider the empirical evidence from the developed economies, the resulting emphasis on the protection of property rights, and investor and minority protections, are relevant to the economies of transition. Sagacious introduction of foreign legal rules are of direct relevance to the emerging markets. Such reforms would yield better results when considered along with the cultural and customary dimensions of the transition economies.

The scholarship on this subject does not provide any guidance as to whether attracting foreign investment and modernizing the corporate governance structure are two inherently divergent policies being pursued by the transition economies. It remains to be examined whether foreign investment in the emerging securities markets will be reduced in the event of the convergence. In this regard, an examination of the patterns of foreign investment in industrial and related sectors vis-à-vis the foreign investment in securities markets may explore, among others: (i) whether corporate governance reforms, in some aspects, are inconsistent with the existing business strategy of cost efficiency for the foreign investors; and (ii) whether higher standards of corporate governance will, ironically, dissuade the foreign investors from dispersing their ownership structure in the emerging securities markets.

Foreign investment policies and corporate governance reforms need to be closely interrelated if the emerging markets intend to open their securities markets for international investors. Future empirical studies focusing on the emerging markets should introduce new areas of inquiry that would help develop strong securities markets, which would play their desired role in the economic growth of the developing world. Such studies should highlight and analyze the role of customary law in shaping the corporate governance regime, foreign investment policies, possibilities of regional integration (of both heterogeneous and homogeneous markets) and the extent of involvement of corporations in CSR initiatives.